

**OFFICE OF THE UNITED STATES TRADE REPRESENTATIVE  
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**UNITED STATES APPEALS PANEL DECISION IN FSC DISPUTE**

The Office of the United States Trade Representative today announced that it has appealed to the WTO Appellate Body the dispute settlement panel decision involving the Foreign Sales Corporation (FSC) provisions of the U.S. Internal Revenue Code.

“We believe that the panel committed multiple legal errors on both substantive and procedural issues, and we will present those errors to the Appellate Body,” stated United States Trade Representative Charlene Barshefsky. “A careful review of the history of this issue, the facts of record, and the applicable WTO legal rules concerning income tax measures should result in a reversal of the panel’s decision.”

The Appellate Body is expected to issue its ruling in late January or early February of next year.

**Background**

In a decision released to the public on October 8, 1999, the panel ruled that the FSC tax exemption constitutes a prohibited export subsidy under the WTO Agreement on Subsidies and Countervailing Measures. The panel also ruled that the FSC tax exemption constitutes an export subsidy for purposes of the WTO Agreement on Agriculture, and violates provisions of that agreement.

The FSC was introduced in the early 1980s after its predecessor provisions, the Domestic International Sales Corporation (DISC) rules, were found to be a prohibited export subsidy under General Agreement on Tariffs and Trade (GATT) subsidy rules. In adopting the ruling against the DISC and certain European tax provisions, the GATT Council expressed an understanding (now also reflected in the WTO Subsidies Agreement) encompassing the following principles:

- economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country need not be subject to taxation;
- such processes should not be regarded as export activities in terms of GATT Article XVI:4 (which essentially prohibits export subsidies on sales of industrial goods);
- arm's length pricing should be observed for tax purposes in transactions between exporting enterprises and related foreign buyers; and
- Article XVI:4 does not prohibit the adoption of measures to avoid double taxation of foreign source income.

The FSC rules permit a portion of income generated outside the territorial limits of the United States to be exempt from U.S. income tax. To qualify for these exemptions, the FSC must have a foreign presence, meet certain management requirements and meet certain economic process requirements addressing both the extent and nature of the sales activities undertaken abroad as well as requiring that a minimum level of direct costs be incurred abroad with respect to certain sales activities (*e.g.*, advertising, order processing, etc.). If export property is sold to a FSC by a related person (or a commission is paid by a related person to a FSC with respect to export property), the taxable income of the FSC and related person is based on transfer pricing rules designed to conform to the arm's length pricing standard in the Subsidies Agreement. (Another qualification limits the tax exemption to a portion of export income resulting from the sale of products of which at least 50 percent of the "fair market value" is attributable to domestic content.)